



**FISCAL AFFAIRS**

# **Expert Opinion on Income Tax Reform Issues**

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The views expressed here are those of the presenter and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.



Thank you for this opportunity – I'm here with 2 colleagues from FAD (Alex Klemm and Shafik Hebous)

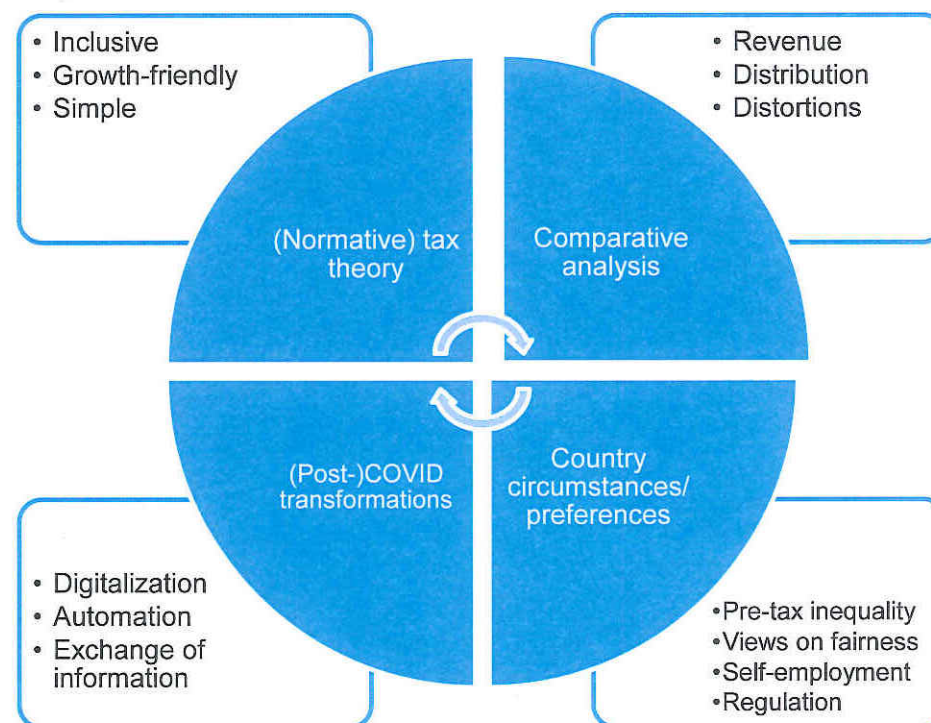
Give short introduction – then eager to answer questions you may have.

I know you already had a lot of contributions – I hope we can add something by sharing insights from our IMF perspective.

# ***“When asked to design a new income tax system for Italy, how would you do it?”***

- **How to tax ...?**
  - Labor income
  - Capital income
  - (Domestic) business income
- ... post COVID-19
- ... in Italy

## ***Framework for Assessment***



When discussing our possible contribution with the Chairman, there was one overarching question that covers almost everything : "...“

This is not about small changes to the current system. It is about rethinking what tax system is needed for Italy in the coming decades, i.e. thinking as if you were to rebuild it from scratch.

How to tax ... ?

- Labor
- Capital – or investment income
- Business: Where the focus here is not so much on international businesses (topic by itself)

We take two approaches:

1. Normative tax theory + evidence-based analysis. What is a good income tax? This determines the key guiding principles.
2. Comparative analysis: how have countries practically implemented their income tax? And how do these systems perform?

Need to take account of changes over time and specific circumstances of countries

3. Technologies are transforming rapidly (including during COVID); and so do international norms for taxation.
4. Every country has its unique characteristics, preferences, policies – all matter for taxation. What is important for Italy?

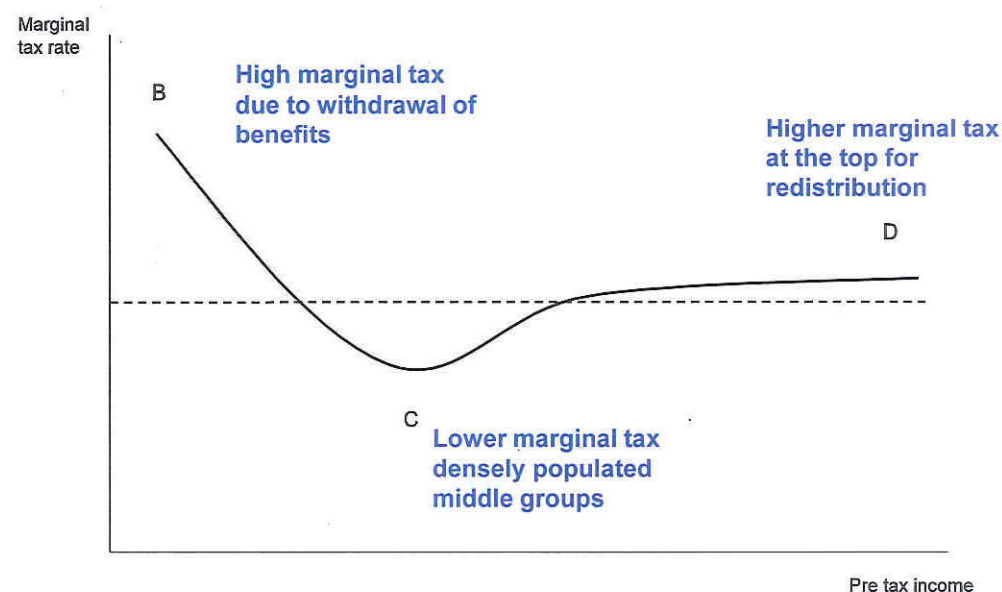
# Taxation of labor income

- **Guidance from tax theory**

- PIT inherently linked to benefits (negative income taxes) – as does social insurance
- Being ‘personalized’, PIT provides opportunity for efficient tailoring of redistribution
- Yet, PIT rates inevitably distort → trade-off
- Key result: “Best” trade-off calls for a U-shaped marginal tax schedule

- **What does this teach us for practical design of the PIT?**

Typical shape of the Optimal Marginal Tax Rate



Source: Illustration by IMF staff based on e.g. Saez (2001) and subsequent literature

Let us start with labor income – by far the largest share of income in most countries.

Normative tax theory provides important guidance:

1. The system is not just about tax, but also benefits (negative taxes). That is similar to social security where contributions are explicitly linked to benefits.
2. The tax-benefit system is the best way to redistribute income from rich to poor because both can be ‘personalized’, i.e. tailored depending on individual’s level of income and other circumstances. Using non-personalized instruments (such as the VAT) is much less efficient – too blunt – to shape progressivity.
3. People will try to escape tax: evade it, avoid it, reduce labor supply, invest less in skills, etc.: tax creates distortions.
4. “Best” trade-off between equity-efficiency is U-shaped marginal tax (= the extra tax for the extra \$ earned).

Picture for the ‘optimal’ marginal tax – how it changes with income – implies important lessons for PIT design

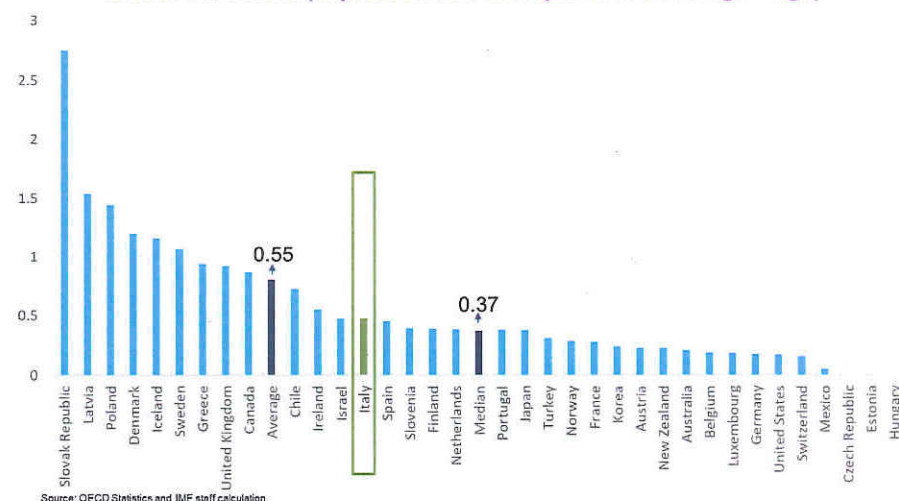
1. High marginal tax at the bottom? This is not due to PIT, but because of benefit withdrawal. Transfers are provided to the poorest households, but should not extend to middle or high incomes – that would be too expensive. This makes it desirable to phase out transfers, which creates a high marginal tax burden (for each \$ more earned, less benefit is received). This distortion is better than the alternative of a very high marginal tax for the middle class.
2. For middle incomes, the transfer should be phased out and the marginal tax rate should be low because you don’t want to impose distortions that affect a lot of people (densely populated middle groups), as that would be very inefficient.
3. For higher incomes, the marginal tax increases again to support redistribution from rich to poor, while distorting only a few people’s behavior.

# Taxation of labor – lower end

- **High marginal tax at the bottom**

- Average tax negative for the poorest (i.e. transfer), but marginal tax is high as benefits are phased out
- Tax itself is low at the bottom: PIT threshold to support progressivity (0-rate, credit or deduction)
- Common in advanced economies, with precise implementation being country-specific – and good calibration important

1st PIT Threshold (expressed as a multiple of the average wage)



- **A case to relieve low-wage earners**

- (Refundable) earned-income tax credit can remove disincentive to work (poverty trap) – increasingly common and increasingly relevant with automation



Interestingly, the U-shape is what most advanced economies actually do – all in their own way.

Means-testing of benefits (or tax credits) is common. So, it's often not the PIT itself that matters, but the removal of benefits. In fact, almost all PIT's have a threshold below which no PIT is paid, to relieve the poor (Picture: the threshold as a percent of the average wage). Countries vary in the level and the phasing out of benefits, so the precise shape of the marginal tax at the bottom differs. But the calibration is important: one can easily get it wrong.

A concern is that the poor get trapped in poverty as the high marginal tax provides a disincentive to earn the extra \$. To reduce this poverty trap, the government can provide special tax credits for people in work with low incomes. Such EITC-like structures at the lower end are increasingly common – and part of the optimal tax structure. The EITC can also reduce labor costs and create jobs for the low-skilled – which is important as these are under strain (e.g. automation).

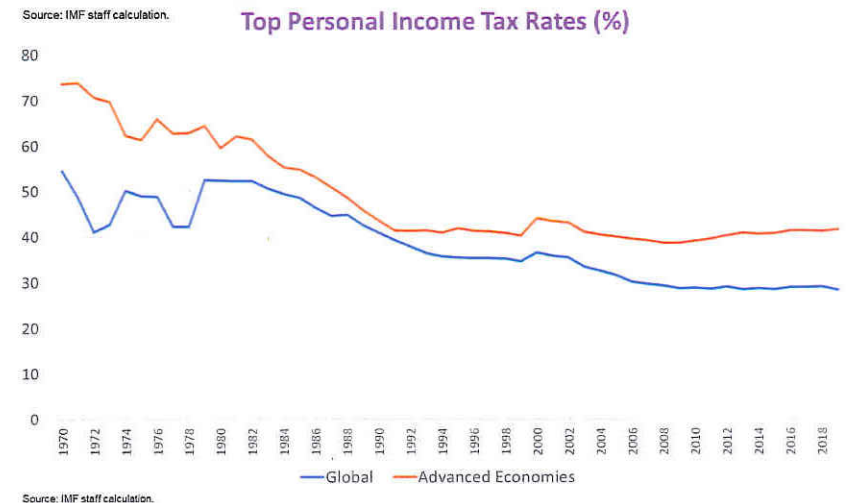
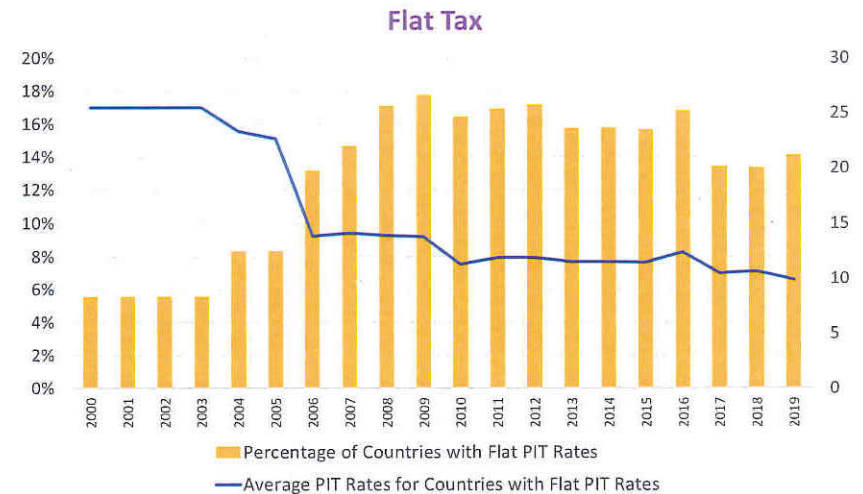
# Taxation of labor – top incomes

- **Top income tax rates**

- A **flat tax** schedule is sub-optimal – one can achieve same redistribution with less distortion
- Distortions impose limits on how high **tax rates** can be – e.g. revenue-maximizing top rate (incl. SSC+VAT) generally estimated between 50-65%

- **Deductions, credits**

- Tax credits are more progressive than deductions if tax rates increase with income
- Some deductions can be ill-placed, e.g. for mortgage interest



The U-shape also implies that a flat tax is not optimal – instead, it suggests a higher tax rate toward the top. Countries with a flat tax are mainly EMEs in Eastern Europe and Central Asia.

- raising the same revenue with a flat tax would shift the burden from the top to middle incomes, which is inefficient;
- flat tax countries often impose a higher tax burden on the middle class (for instance, due to a high SSCs and high VAT rate);
- they often try to introduce progressivity through e.g. VAT exemptions, which are blunt and inefficient ways to achieve this.

It is much better to use the PIT to make the tax system progressive and avoid high marginal tax on middle class.

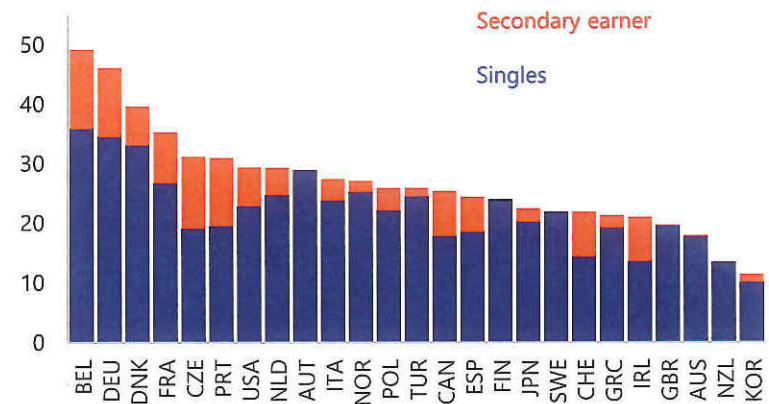
There are limits too. Distortions mean that an additional increase in the tax rate might beyond some point reduce overall revenue. That can never be optimal. Again: this will be country-specific.

Tax expenditures. We generally caution against their use, although some deductions might be justified as genuine costs to produce earnings – e.g. education expenses. Some tax expenditures can create their own distortions, such as those on mortgage interest. Each tax expenditure will need to be assessed on a case-by-case basis.

# Taxation of labor – families

- **What should be the tax unit?**
  - Family taxation generally discourages female labor supply – less efficient
  - International trend has been toward individualization

Average personal net tax rates when entering employment



Sources: OECD(2016), IMF staff calculations

A key question is how to tax people in families: as a household unit, or as individuals?

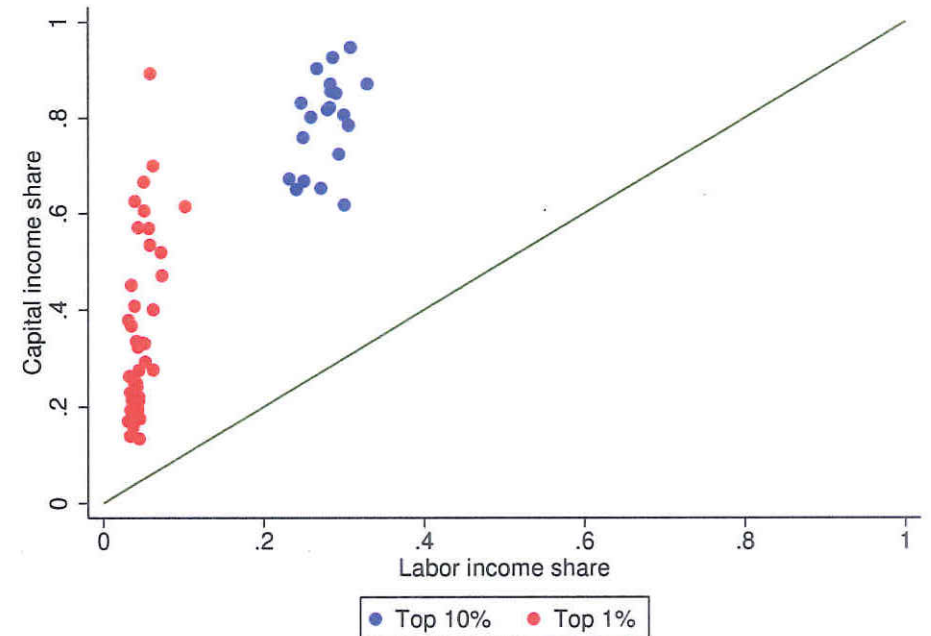
Importantly, household taxation can discourage labor supply of the secondary earner – that with the lowest income – because the additional \$ earned will be taxed at a high rate if the primary earner has a high income. This can reduce especially female labor supply. Like Italy, most AEs have therefore moved toward individualized systems.

Picture: shows the tax paid by someone who starts working. It compares a single person with a second earner in a couple. Family-based aspects often increase the participation tax (the orange part) for secondary earners in couples – relative to singles. In Italy, this is the case due to the tax credit for dependent relatives.

# Should capital income be taxed?

- **Above-normal return → yes**
  - Equitable and efficient
- **Normal return → ?**
  - Views from '80s suggest avoiding saving distortion either by exempting normal return or deducting savings (often done for pension savings)
  - Emerging consensus is that taxation of capital income has merit, even for efficiency – but perhaps at a lower (top) rate than labor
- **Equity concerns reinforce the case**
  - Capital income highly concentrated at the top
  - Capital income share in national income has been rising in recent decades

Capital and Labor Top Income Shares, 2018 or latest



Source: LIS and IMF staff calculations

Capital income – interest, dividends, capital gains.

In tax theory, there is controversy whether capital income should be taxed. That doesn't apply to excess returns or 'rents' on which the consensus is that they should be taxed. But it does apply to 'normal returns', i.e. the minimum required to compensate people for saving.

Some economists argued that the normal return should not be taxed, because it distorts savings and that is highly inefficient. Hence, they say that savings should be deductible (as many countries do for pension savings); or there should be a deduction for the normal return (as, for example, Norway does).

# How to tax capital income?

- **Global vs schedular income tax**

- Countries generally moved away from theoretical ideal of 'global income tax' toward more pragmatic 'schedular' systems

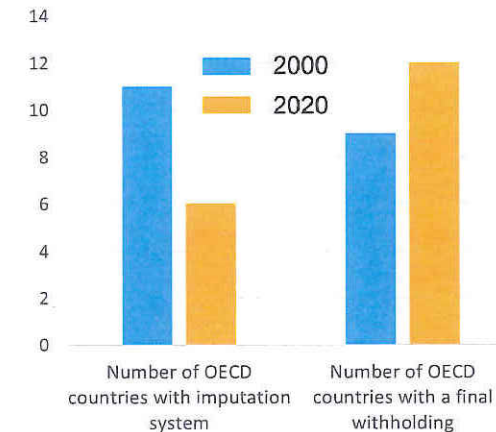
- **Integration of CIT and PIT**

- Imputation systems lost ground in Europe
- Equity is double-taxed (CIT + PIT), but rates have generally declined

- **Neutrality as guiding principle**

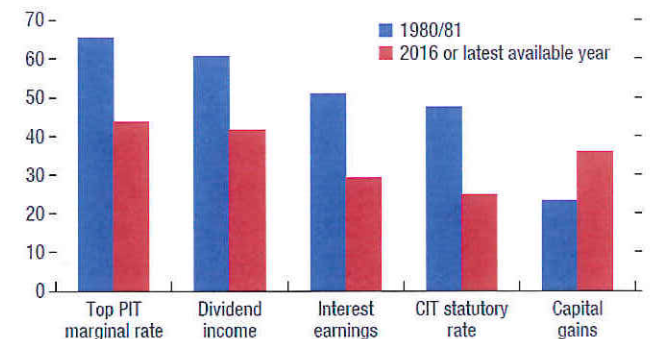
- Differential taxation of interest, dividends and capital gains induces distortions/avoidance → case for a uniform flat tax rate on capital
- ACE supports neutrality at corporate level for debt vs equity

Taxation of Dividends



Source: OECD Statistics and IMF staff calculation. The total number of countries is 36 (in 2000 and in 2020)

Capital income tax rates in OECD



Sources: Carey, Chouraqui, and Hagemann 1993; and Harding and Marten 2018.  
Note: CIT = corporate income tax; OECD = Organisation for Economic Co-operation and Development; PIT = personal income tax.



For long, the theoretical ideal has been the Haig-Simons Global Income Tax (GIT): each dollar contributes to a person's 'ability-to-pay' and should add to its taxable income. But countries have moved away from this theoretical ideal for pragmatic reasons: it has been difficult to administer, especially for personalized capital income. This led countries to adopt 'schedular' systems – a separate treatment for labor and capital (and sometimes business income).

Capital income is taxed by CIT and PIT. Imputation systems to offset the withheld CIT for the PIT (still in 6 OECD countries, but in decline) have disappeared in Europe's integrated capital market. Countries have often reduced tax rates (CIT and PIT) to mitigate the double-tax issues. The overall tax burden on capital nowadays is in fact lower than a few decades ago (Picture).

Designs and rates of capital income tax vary widely across countries. Often dividends are taxed more than interest/capital gains – causing distortion and avoidance. Neutral taxation should be the guiding principle. In Italy the schedule is quite neutral; and the ACE is a good basis to eliminate distortion between debt and equity at the corporate level.

# Taxation of business income

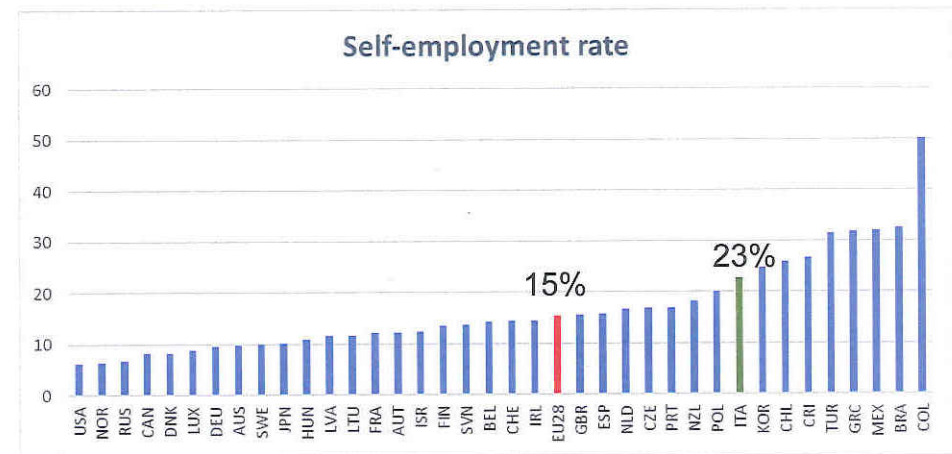
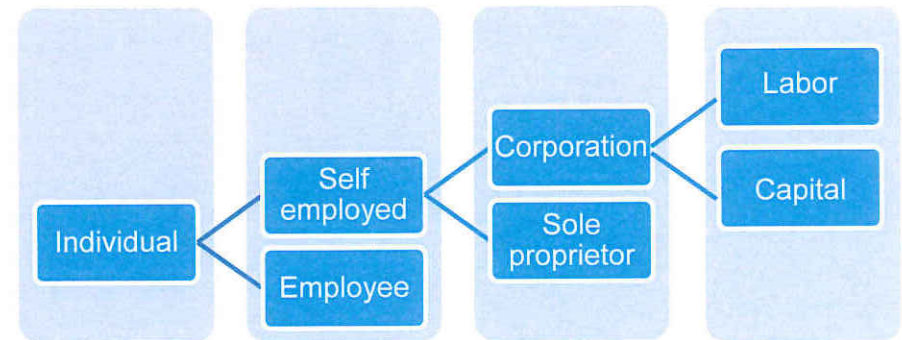
- **Entrepreneurial income**

- Blurred distinction labor vs capital income
- Several margins of distortion
- Relevant for Italy – large share self-employed
- Increasingly relevant in peer-to-peer economy

- **Tax neutrality as guiding principle**

- Tax on labor vs capital should not be too different
- ‘Transparent’ PIT treatment of corporations (e.g. S-corps in the U.S.; partnerships)
- Specific allocation rules under ‘dual income tax’
- Simplified regime for very small businesses should not be a ‘preferential regime’

*Margins of distortion for entrepreneurs*



Source: OECD Employment Outlook

For entrepreneurs, it is often unclear if income is associated with labor efforts or investment in the private business. The blurred distinction would be no problem under a perfectly enforced GIT – but it is under schedular systems. There can be several margins of distortion if the system is not sufficiently neutral. Countries deal with this in various ways.

Tax neutrality should be the guide. Best by taxing capital and labor income at similar marginal tax rates. But if they do differ, solutions may be found with e.g. transparent tax regimes (that look through the corporate veil) or allocation rules for what is labor and capital income. Simplified regimes are sometimes used to reduce tax compliance costs for SMEs – but these regimes should not be ‘preferential’ as that would create distortions (e.g. splitting up companies, or discourage firm growth).

# Enforcement - Compliance

- **Withholding**

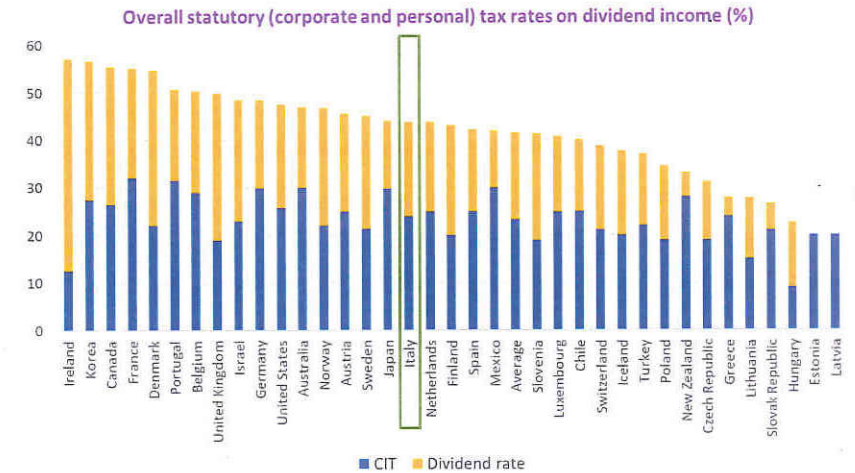
- PAYE for salaries
- (Final) withholding taxes on interest and dividends where feasible

- **Corporate tax**

- CIT as backstop – though is under pressure
- Taxation of capital gains upon accrual remains hard – and upon realization creates its own distortions

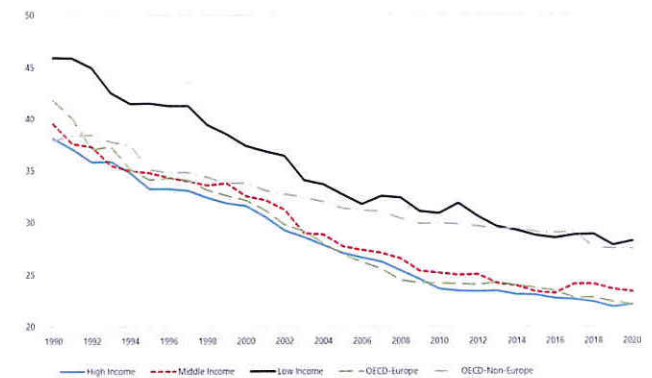
- **Information**

- Exploit third-party information – including international exchange of information (and digital technologies)



Source: OECD Statistics and IMF staff calculation.

## Corporate tax under pressure



Source: IMF Tax Database

Tax design is often determined by what is administratively feasible and a system that ensure good tax compliance. A few administrative principles are important:

1. Withholding is key. For capital income, final withholding might have appeal for simplicity and has been on the rise. It also generally supports compliance.
2. CIT as a withholding mechanism is a critical backstop. Putting enforcement on the PIT is more problematic, especially for retained earnings (capital gains) which are generally taxed only upon realization.
3. Exploit third-party information, not rely on individual filing. For capital income, this was long a problem for offshore capital income that led to tax evasion. But this might now be changing with Automatic Exchange of Information as the new global standard. Ultimately, tax compliance is critical.

## ***“When asked to design a new income tax system for Italy, how would you do it?”***

### Taxation of labor income

- Follow U-shape marginal tax – no flat tax – with careful calibration of tax rates and phase-outs
- In-work credits alleviate poverty traps
- Individual taxation supports female labor

### Taxation of capital income

- Neutrality best achieved through uniform flat rate (combined CIT + PIT)
- Rate somewhat below or close to top PIT rate on labor
- Use withholding and third-party information

### Taxation of business income

- Neutral with respect to legal form
- Limit difference between labor and capital income

To summarize – and reflect on how desirable PIT design compares with the current Italian system:

### Labor income

- Like most countries, Italy largely seems to follow the U-shape. It might be useful to verify if calibration can be improved, e.g. if phase-outs, tax rates and tax credits do not impose high marginal tax rates where it affects a large group of workers.
- Italy has in-work credit for the PAYE. It might explore whether its design is good or can be improved.
- Italy has an individualized system, but with some family-based deductions that add to the tax wedge on secondary earners.
- Overall: the tax wedge in Italy appears relatively high across the board (including social security).

### Capital income

- Italian system is broadly in line with a dual income tax approach. Rates on different types of capital income are mostly neutral – perhaps with some exceptions for special investments (e.g. housing). The ACE regime helps mitigate the distortion between debt and equity.
- The combined rate on capital income (CIT + PIT) seems pretty close to the top rate on labor.

### Business income

The special regime for SMEs seems relative generous and might induce avoidance.



**Thank You!**